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No. 88-1238

In the Supreme Court of the United States

OCTOBER TERM, 1988

CLEMON J. HERRINGTON AND IVY C. HERRINGTON,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether the court of appeals correctly held that, after petitioners had received the benefit of losses claimed on their 1976 tax return with respect to their 1976-1977 "commodity straddle" transaction, petitioners were estopped by the duty of consistency in federal tax reporting from disavowing the gain they had reported on their 1977 federal income tax return with respect to that transaction by claiming that the transaction was a sham.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A2-A6) is reported at 854 F.2d 755. The opinion of the Tax Court is not reprinted in the appendix to the petition but is reported as *Glass* v. *Commissioner*, 87 T.C. 1087.

JURISDICTION

The judgment of the court of appeals was entered on September 13, 1988. A petition for rehearing was denied on November 1, 1988 (Pet. App. A7). The petition for a writ of certiorari was filed on January 26, 1989. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. This case involves the federal income tax consequences of petitioners' involvement in a commodity

trading scheme known as a London option straddle transaction, which was designed to create favorable tax consequences. A London option straddle consisted of a series of integrated commodity straddle trades in option and forward contracts on the London Metal Exchange, generally taking place over a span of two years.[1] The transaction was designed to achieve a prearranged tax result – a loss in the first year of the straddle and an offsetting capital gain in the second year, thus allowing participants to defer ordinary income from one year to the next and to convert that ordinary income into capital gain. See *Glass* v. *Commissioner*, 87 T.C. 1087, 1095, 1104-1107 (1986).[2]

Petitioners entered into two London option straddle transactions. The first straddle transaction was initiated in 1976 and closed in 1977. The transaction purportedly resulted in an ordinary loss of $60,244 in 1976 and a

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[1] An option gives the holder the right to sell (put) or to buy (call) from the grantor a specific quantity of a commodity at a specified price at any time up to a date certain in the future. A forward contract is an agreement to buy (long) or sell (short) a specific quantity of a commodity at a specified price on a date certain in the future. A straddle involves the simultaneous holding of a buy and sell position in the same commodity.

[2] *Glass* v. *Commissioner*, *supra*, involved nearly 1400 London option straddle transaction cases, including petitioners', that were consolidated in the Tax Court. Appeals from decisions entered by the Tax Court pursuant to its opinion in *Glass* have been filed in ten circuits by various of the taxpayers involved in those consolidated cases. To date, seven courts of appeals have ruled, all affirming the decisions entered by the Tax Court pursuant to its *Glass* opinion. *Dewees* v. *Commissioner*, No. 87-1763 (1st Cir. Mar. 15, 1989); *Friedman* v. *Commissioner*, No. 87-1154 (4th Cir. Mar. 3, 1989); *Ratliff* v. *Commissioner*, 865 F.2d 97 (6th Cir. 1989); *Keane* v. *Commissioner*, 865 F.2d 1088 (9th Cir. 1989); *Killingsworth* v. *Commissioner*, 864 F.2d 1214 (5th Cir. 1989); *Kirchman* v. *Commissioner*, 862 F.2d 1486 (11th Cir. 1989); *Yosha* v. *Commissioner*, 861 F.2d 494 (7th Cir. 1988).

capital gain of $54,232 in 1977. The second straddle transaction was initiated in 1977 and was closed in 1978. That transaction purportedly resulted in a capital loss of $60,041 in 1977 and a capital gain of $59,686 in 1978. Petitioners reported these losses and gains on their federal income tax returns for the relevant years. Pet. App. A3.

On June 10, 1980, after the statute of limitations on assessing any additional tax liability with respect to petitioners' 1976 tax year had expired, the Commissioner began an audit of their London option straddle transactions. The Commissioner determined that these straddle transactions were shams. Accordingly, with respect to petitioners' 1977-1978 straddle transaction, the Commissioner disallowed the 1977 capital loss of $60,041 and eliminated the 1978 capital gain of $59,686. Because the disallowance of the $60,244 loss claimed by petitioners on the 1976 half of their 1976-1977 straddle transaction was barred by the statute of limitations, however, the Commissioner did not eliminate the 1977 gain of $54,232 they had reported on their return for that year. Pet. App. A3; Doc. 2, Exh. A; Doc. 24.[3]

2. Petitioners filed a petition for redetermination of the 1977 deficiency with the Tax Court. Their principal argument was that the straddle transactions were not shams and therefore that the Commissioner improperly disallowed the claimed loss. Petitioners also asserted, without explanation, that the Commissioner erred in his determination of capital gain of $54,232. In a unanimous, reviewed opinion covering nearly 1400 consolidated cases (see note 2, *supra*), the Tax Court held that the London option transactions lacked economic substance and therefore that the taxpayers were not entitled to deduct the

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[3] "Doc." references are to the documents comprising the original record on appeal as numbered by the Clerk of the Tax Court.

resulting losses. *Glass* v. *Commissioner, supra.* Consistent with its determination that the London option transactions were shams, the court further held that the gains generated by the transactions did not constitute taxable income to the taxpayers. Specifically, the Tax Court stated (87 T.C. at 1177):

> In conclusion, we hold that the London option transaction—petitioners' multiple and complex tax straddle scheme encompassing prearranged results—lacked economic substance and was a sham. Petitioners consequently may not deduct the losses claimed by them in year one of their straddle transactions. It follows, of course, that since the straddle transactions were a sham, gains reported by petitioners in year two and thereafter do not constitute taxable income to them, and we so hold.

Subsequently, the Tax Court entered a decision determining a deficiency in petitioners' 1977 tax year in the amount asserted by the Commissioner, which included the gain petitioners had reported on their 1977 return (Pet. App. A1). Petitioners thereafter filed a motion requesting the Tax Court to revise its decision to eliminate the 1977 gain, contending that this revision was necessary to conform the decision to the court's opinion holding the straddles to be shams. Petitioners' motion was denied without opinion (Docs. 22-24).

3. Petitioners did not challenge on appeal the Tax Court's determination that the London option transactions were shams; they argued only that the 1977 gain that they reported on the transaction should have been eliminated by the Tax Court. The court of appeals rejected this argument and affirmed (Pet. App. A2-A6). The court held that, because petitioners had treated the transaction as bona fide in claiming a loss deduction on their 1976

return and correction of that erroneous deduction was barred by the statute of limitations, the duty of consistency in federal tax reporting required that petitioners be estopped from contending that the transaction was a sham for purposes of reducing their tax liability for 1977 (*id.* at A4-A6). The court set forth the elements of the duty of consistency as follows—"1) a representation or report by the taxpayer; 2) on which the Commissioner has relied; and 3) an attempt by the taxpayer after the statute of limitations has run to change the previous representation or to recharacterize the situation in such a way as to harm the Commissioner" (*id.* at A5)—and it explained that these elements were clearly satisfied here.

ARGUMENT

The court of appeals correctly held that the duty of consistency in federal tax reporting prevents petitioners from arguing that their 1977 gain on the straddle transaction should not be recognized because the transaction was a sham. The established requirements for the application of the duty of consistency are that: "(1) the taxpayer has made a representation or reported an item for tax purposes in one year, (2) the Commissioner has acquiesced in or relied on that fact for that year, and (3) the taxpayer desires to change the representation, previously made, in a later year after the statute of limitations on assessments bars adjustments for the initial tax year." *Beltzer* v. *United States*, 495 F.2d 211, 212 (8th Cir. 1974); see also *Crosley Corp.* v. *United States,* 229 F.2d 376, 380-381 (6th Cir. 1956); *Orange Securities Corp.* v. *Commissioner,* 131 F.2d 662, 663 (5th Cir. 1942). The court of appeals followed this test here (see Pet. App. A5), and it correctly found that each of the requirements is satisfied in this case. First, by claiming the ordinary loss deduction on their 1976

return, petitioners had represented to the Commissioner that the 1976-1977 straddle transaction was not a sham. Second, in accepting the 1976 return as filed, the Commissioner relied on this representation. Third, now that the statute of limitations bars reconsideration of the 1976 return, petitioners assert that the 1976-1977 straddle transaction was a sham in an effort to reduce their 1977 tax liability by disavowing the gain reported on their return.

The decision below thus is merely a correct application of settled legal principles to a particular set of facts. It is certainly not "a dangerous expansion of the Commissioner's power to evade the three year statute of limitations" (Pet. 6). Indeed, the decision below does not expand the doctrine of the duty of consistency at all. Nor does it recognize any "power to evade the * * * statute of limitations"; the determination that petitioners must recognize the gain they reported on their 1977 return relates only to their tax liability for a year that is not closed by the statute of limitations.[4]

Petitioners' contention on the merits rests entirely upon the premise that the 1976-1977 straddle transaction may not be considered one transaction but, instead, must be viewed as two separate transactions. See Pet. 7-8. This premise also forms the basis for petitioners' specious assertion (Pet. 12) that this case would have been decided dif-

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[4] Petitioners' contention (Pet. 7) that the application of the duty of consistency here abrogates their right to advance alternative arguments is misconceived. The estoppel applied by the courts below is predicated upon the inconsistency between petitioners' treatment of the first half of the London option transaction on their 1976 return and the treatment they now seek with respect to the second half of the transaction for their 1977 taxable year. The fact that they maintained alternative positions in the Tax Court with respect to 1977 is not objectionable and has nothing whatever to do with the application of the duty of consistency here.

ferently in the Eighth Circuit, even though the court below followed the analysis of the Eighth Circuit's *Beltzer* decision. Based on this premise, petitioners contend that they never changed their position with respect to a *single* transaction (Pet. 6-7), that the "alleged" change of position related only to an open year (1977), not to a closed year that would implicate the duty of consistency (Pet. 8, 11-12), and that they make no representation at all with respect to the statute-barred year (1976) (Pet. 10-12). The premise of petitioners' argument is completely unfounded. The two legs of the straddle are interrelated, and it is plainly inconsistent for petitioners to claim a loss on one leg on the theory that the transaction is bona fide and to disavow a gain on the other leg on the theory that the transaction is a sham.

Petitioners' sole authority for their novel assertion that the legs of a single commodity straddle transaction must be considered separate transactions is *Smith* v. *Commissioner*, 78 T.C. 350 (1982), aff'd, 820 F.2d 1220 (4th Cir. 1987) (Table). But, contrary to petitioners' assertion, the Tax Court in *Smith* did not hold that the separate legs of a straddle must be viewed as separate transactions. The court merely held that, in the case of straddle transactions spanning more than one year and that were not held to be shams, the Commissioner could not use the step transaction doctrine to preclude the taxpayer from deducting losses incurred in the first year of the transaction. In so holding, the court expressly recognized that the straddle transaction constituted a single transaction even though the tax effects of the transaction were reportable in different years. The court stated (78 T.C. at 389): "Respondent has not pointed us to any court decision which to this date has held that the step transaction doctrine requires that gains and losses in a tax sheltering investment spanning the course of more than 1 taxable year must be in-

tegrated and recognized only at the termination of such an investment 2, 5, or 20 years down the road." The court in *Smith* thus viewed the straddle transaction as a single transaction spanning more than one year, and its decision is fully consistent with the application of the duty of consistency by the court below.

Moreover, viewing the two legs of a straddle transaction as component parts of a single transaction is entirely consistent with the economic realities of investments in straddles. As the Tax Court explained in *Glass* (87 T.C. at 1102-1103), the potential for profit from a legitimate straddle transaction arises from changes in the price differential between the legs of the straddle, not from an increase or decrease in the value of an individual leg. Thus, while the closing of an individual leg may give rise to an immediately recognizable gain or loss, the straddle investment consists of both legs. Accordingly, there is no basis for petitioners' attempt to secure a windfall by taking a loss deduction on one leg of the straddle and then avoiding gain on the other leg by claiming that the transaction is a sham.[5]

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[5] Petitioners assert (Pet. 8) that the court of appeals erroneously based its determination that they had changed their position regarding the validity of their London option transaction on their failure to appeal the holding of the Tax Court that the London option transactions were shams. This assertion is mistaken. Petitioners' change of position occurred, not by virtue of their failure to appeal that holding of the Tax Court, but rather from their reliance on that holding to disavow their prior representation that the 1976-1977 transaction was bona fide. The fact that their new position is based on the decision of the Tax Court is irrelevant. The critical facts are that petitioners originally represented on their 1976 return, in claiming a loss deduction, that the London option was bona fide and, after the statute of limitations barred correction of that return, they took the opposite position in order to disavow the gain they had reported on their 1977 return.

CONCLUSION

The petition for a writ of certiorari should be denied.
Respectfully submitted.

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